

MAKING SENSE OF *THIS* WORLD

11 June 2018



R&R Weekly Column
By Brunello Rosa




Central Banks Return to Centre Stage


Immediately after the disastrous conclusion of the G7 meeting in Canada (which we anticipated in [last week's column](#)), and ahead of this week's historical meeting between US President Donald Trump and North Korea's leader Kim Jong-un, central banks return to centre stage, with the policy meetings of the US Federal Reserve, the ECB and the Bank of Japan. In line with consensus, we don't expect any change in BOJ's policy stance, especially after the Japanese economy contracted by 0.2% in Q1, and inflation has fallen back from the 1.5% yearly increase recorded in February to 0.6% recently. Following our [recent analysis](#), and on the back of these data, we don't expect the BOJ to make any significant change to its communication until March 2019 at least. Regarding the ECB, [we expect the Governing Council](#) to start its discussion on if and how to continue with its asset purchase program, but we don't expect any major announcement to be made at this stage yet. The major obstacles to pre-commitments are the ongoing soft patch the EZ economy is experiencing and the resurgent political instability, following the formation of new governments in Spain and in Italy (on which we publish [a working paper in bullet points](#)).


Regarding the Fed, in line with consensus, we expect a 25-bps increase in its Fed funds target range to 1.75-2.0%, while [we don't expect the dot plot to indicate four total hikes in 2018 yet](#). The key aspect of this policy meeting might be the repercussions that a further increase in US rates and strengthening of USD might have on emerging markets. As we discuss in greater detail in the section "The Quarter Ahead," the recent increase in US policy rates, reduction in the Fed's balance sheet and dollar appreciation are starting to generate significant outflows of funds from EMs, forcing some central banks to implement "defensive" rate hikes or FX interventions to defend the value of their currencies (with Brazil, Indonesia, Mexico and [India](#) having joined [Turkey](#) and [Argentina](#)). As discussed in [a recent article for the FT](#) by India's central bank governor Urjit Patel, the combination of Fed's balance sheet reduction and increased issuance of US Treasury bills and notes to finance the higher fiscal deficit due to [Trump's tax cuts](#), is creating a dollar shortage that is putting pressure on EM currencies (especially of the most fragile countries). Initially, the Fed might shrug off the effects of its policies on other countries, but eventually it might be forced to look back into it. If the dollar appreciates notably, its policy normalisation to control inflation dynamics might afford to be slower than otherwise. If the rest of the world goes into an economic slowdown as a result of localised (but numerous) [currency crises](#), global growth will also slow down eventually, thus affecting the Fed's policy path. It will be interesting to watch whether or not Jay Powell, in his press conference on Wednesday, will address this issue.

Our Recent Publications


 [Working Paper: Bullet Points on Italy - New Government to Be Initially Only Modestly Confrontational with Europe](#), by Brunello Rosa and Nouriel Roubini, 11 June 2018

 [Fed Preview: Hike in June Done Deal, Four Hikes in 2018 Not Yet](#), by Nouriel Roubini and Brunello Rosa, 11 June 2018

 [ECB Preview: Discussion on QE Extension to Begin in June, But No Rush to Decide](#) by Rosa and Roubini, 8 June 2018

 [Post-Brexit Customs Options Mask Deeper Choices](#) by Brunello Rosa and Nouriel Roubini, 6 June 2018

 [Germany Remains Cautious On Further Eurozone Integration](#) by Brunello Rosa and Nouriel Roubini, 5 June 2018

 [China Travel Notes: Reforms and Rebalancing to Remain Gradual](#), by Nouriel Roubini, 4 June 2018

The Week Ahead

The Fed, the BoJ and the ECB will hold policy meetings. The Fed will likely hike rates to 1.75-2% on June 12, on inflation rising to 2.6% y-o-y (CPI May, *p*: 2.5%). No policy change is expected from the BoJ and the ECB, whose press conference will be closely watched.

The ECB is likely to start a discussion on QE extension, but we don't expect to make major announcements just yet. Over the past week, [Peter Praet's speech](#) helped a rise in 10y bond yields in: Germany (+5bps to 0.45% w-o-w), Italy (+44bps, to 3.13% w-o-w) and Spain (+3bps, to 1.47% w-o-w). In Q1, EZ growth was stable (EZ GDP growth Q1 y-o-y, *a*: 2.5%; *c*: 2.5%; *p*: 2.5%) and is expected to remain relatively firm (Markit Comp. PMI May, *a*: 54.1; *c*: 54.1; *p*: 54.1) while inflation is likely fall back, after the increase to 1.9% recorded in May (*c*: 1.9%; *p*: 1.2%).

The US and North Korea leaders will meet on Tuesday. The meeting is expected to reduce tensions between the two countries.

The Quarter Ahead

US - The Fed and the government will reduce global liquidity in USD ... In the US: *a*) the Fed will accelerate the pace of reduction of its BS from USD 30bn per month in Q2, to 40bn in Q3 and 50bn in Q4 2018; *b*) the US government will increase bond issuance to fund infrastructure spending and the deficit created by the recent tax cuts; while *c*) the Fed will keep hiking rates: the market-implied likelihood of a 25bps hike at the June 12-13 FOMC meeting stands at 91% (*pw*: 93%), while the likelihood of "at least three" and "at least four" hikes in 2018 remains at 83% (*pw*: 83%) and 39% (*pw*: 37%), respectively (CME); All these factors will contribute to absorb USD liquidity.

... Creating the risk of outflows from EMs, and forcing rate hikes. In a context of declining USD liquidity, rising US interest rates and strengthening USD, EMs are vulnerable to outflows, particularly in the fixed income space. EM CBs will likely be forced to increase interest rates to prevent currency depreciation, in line with last week's moves: *a*) the CB of [Brazil](#)—while the government is dealing with a wave of strikes and political uncertainty ahead of the October presidential election—had to repeatedly intervene to stop the slide of the BRL, which depreciated by 16% since the end of March. As a result, the BRL strengthened by 1.6% w-o-w to USD/BRL 3.71; *b*) for the first time since 2014, [India's](#) CB raised its benchmark interest rate by 25bps to 6.25% and set the stage for a gradual tightening cycle; *c*) in [Turkey](#)—where the political and economic environment will remain volatile until the election in June 24—the CBT surprised the markets with the decision to hike, for the third time in less than two months, its 1-week policy rate by 125bps (to 17.75), leading to a 3.4% appreciation of the TRY to USD/TRY 4.49; while *d*) [Argentina](#) secured an IMF's USD 50bn credit line, which should reduce currency vulnerability. Last week, the EM currency index weakened by 0.4%.

In the near term, trade tensions will continue, but will not lead to a trade-war. The G7 meeting closed yesterday without progress. The U.S. and China will continue to haggle: this week, China reiterated its willingness to increase imports from the US, were the US to make concessions.

GCC - High oil prices will delay fiscal consolidation efforts. In the UAE, both Abu Dhabi and Dubai announced measures to boost growth through fiscal stimuli.

Bond issuance in MENA will remain elevated. New MENA bonds amount to USD 49.8bn y-t-d, equivalent to 57.6% of 2017's total issuance of USD 86.4bn.

Opec will increase output. Brent spot prices fell by 0.4% w-o-w to 76.5 USD/bbl on speculation that Saudi Arabia and Russia—which have scheduled talks next week—will agree to wind down existing production limits.

Last Week's Review

Global markets, driven by technology stocks, ignored concerns over the simmering US-China trade dispute. The S&P500 rose by 1.6% w-o-w—completing three consecutive weeks of gains for the first time since January—and volatility (VIX) declined w-o-w by 1.2 points to 12.2. The 10-y UST yield rose by 5bps w-o-w to 2.95%. The USD depreciated against a basket of currencies (DXY down by 0.4% w-o-w) and—as fears of populism receded in Europe—remained unchanged against the EUR, at EUR/USD 1.177. Helped by a softer USD, gold rose by 0.4% to 1,298 USD/oz. and copper reached a 4.5-year high (7,300 USD/tn), boosted by fears of strikes in Chile.

Pablo Gallego Cuervo and Renata Bossini contributed to this Viewsletter.

The picture in the front page comes from [this website](#)



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Abbreviations, Acronyms and Definitions

<i>a</i>	Actual	<i>IS</i>	Islamic State
<i>AKP</i>	Justice and Development Party	<i>JPY</i>	Japanese yen
<i>ann.</i>	annualized	<i>k</i>	thousand
<i>ARS</i>	Argentinian Peso	<i>KSA</i>	Kingdom of Saudi Arabia
<i>bn</i>	Billion	<i>LN</i>	Northern League
<i>BCB</i>	Central Bank of Brazil	<i>MSS</i>	Five Star Movement
<i>BoC</i>	Bank of Canada	<i>m-o-m</i>	Month-on-month
<i>BoE</i>	Bank of England	<i>mb</i>	Million barrels
<i>BoJ</i>	Bank of Japan	<i>mb/d</i>	Million barrels per day
<i>bpd</i>	Barrels per day	<i>MENA</i>	Middle East and North Africa
<i>bps</i>	Basis points	<i>mn</i>	Million
<i>BS</i>	Balance sheet	<i>NAFTA</i>	North-American Free Trade Agreement
<i>c</i>	Consensus	<i>OECD</i>	The Organization for Economic Cooperation and Development
<i>C/A</i>	Current account	<i>Opec</i>	Organization of Petroleum Exporting Countries
<i>CB</i>	Central bank	<i>p</i>	Previous
<i>CBK</i>	Central Bank of Kuwait	<i>pw</i>	Previous week
<i>CBO</i>	US Congressional Budget Office	<i>PCE</i>	Personal Consumption Expenditures
<i>CBR</i>	Central Bank of Russia	<i>PE</i>	Price to earnings ratio
<i>CBT</i>	Central Bank of the Republic of Turkey	<i>PM</i>	Prime minister
<i>CDU</i>	Christian Democratic Union of Germany	<i>PMI</i>	Purchasing managers' index
<i>CNY</i>	Chinese Yuan	<i>pps</i>	Percentage points
<i>CBT</i>	Central Bank of the Republic of Turkey	<i>QCB</i>	Qatar Central Bank
<i>CPI</i>	Consumer Price Index	<i>QAR</i>	Qatari Riyal
<i>DJIA</i>	Dow Jones Industrial Average Index	<i>QE</i>	Quantitative easing
<i>d-o-d</i>	Day-on-day	<i>q-o-q</i>	Quarter-on-quarter
<i>DX</i>	US Dollar Index	<i>RBA</i>	Reserve Bank of Australia
<i>EC</i>	European Council	<i>REER</i>	Real Effective Exchange Rate
<i>ECB</i>	European Central Bank	<i>RUB</i>	Russian Rouble
<i>EIA</i>	US Energy Information Agency	<i>tb/d</i>	Thousand barrels per day
<i>EM</i>	Emerging Markets	<i>tn</i>	Trillion
<i>EP</i>	European Parliament	<i>TPP</i>	Trans Pacific Partnership
<i>EPS</i>	Earnings per share	<i>TRY</i>	Turkish Lira
<i>EU</i>	European Union	<i>UAE</i>	United Arab Emirates
<i>EUR</i>	Euro	<i>UK</i>	United Kingdom
<i>EZ</i>	Eurozone	<i>US</i>	United States
<i>Fed</i>	US Federal Reserve	<i>USD</i>	United States Dollar
<i>FM</i>	Future Movement	<i>USD/bbl.</i>	USD per barrel
<i>FOMC</i>	US Federal Open Market Committee	<i>UST</i>	US Treasury bills/bonds
<i>FRB</i>	US Federal Reserve Board	<i>VAT</i>	Value added tax
<i>FX</i>	Foreign exchange	<i>VIX</i>	Chicago Board Options Exchange Volatility Index
<i>FY</i>	Fiscal Year	<i>WTI</i>	West Texas Intermediate
<i>GCC</i>	Gulf Cooperation Council	<i>w-o-w</i>	Week-on-week
<i>GBP</i>	British pound	<i>y-o-y</i>	Year-on-year
<i>GDP</i>	Gross domestic product	<i>y-t-d</i>	Year-to-date
<i>GOP</i>	Grand Old Party (US Republican Party)	<i>ZAR</i>	South African Rand
<i>IMF</i>	International Monetary Fund	<i>10-y</i>	10 year
<i>INR</i>	Indian Rupee	<i>ZEW</i>	Centre for European Economic Research
<i>IPO</i>	Initial public offering		



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